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IMPACT OF U.S. FINANCIAL AND ECONOMIC DISTRESS ON SOUTH KOREA

By Thomas F. Cargill

Introduction

Korea's economy in 2008 was adversely impacted by high commodity prices, especially oil, and by financial and real shocks started by the collapse of housing prices in the United States and subsequent economic and financial distress that rapidly spread throughout much of the world. Commodity prices have declined, but the continuing economic and financial distress in the United States will continue to impact Korea. Korea's exports have declined significantly in the last few months, the economy slowed and in 2008:4 gross domestic product declined by 3.4 percent, and government policymakers will face a number of macroeconomic and financial stability issues in the next few years. Nonetheless, Korea's economy to date has absorbed the shocks without the degree of distress exhibited in late 1997 and 1998. Although Korea continues to face major long-run challenges, as outlined by the most recent OECD economic survey of Korea,[1] Korea's flexibility in dealing with the current distress illustrates how much progress has been achieved since 1997–98. Not only has the Korean economy absorbed the current shocks without intense distress, but the commitment toward continued reform exhibited by Korean authorities provides a foundation for dealing with the longer-run challenges. This cautiously optimistic view needs to be conditioned, however, by the fact the Korean economy is declining much faster than anticipated; and how Korea adapts to the economic and financial distress is dependent on factors outside of its control because of Korea's heavy reliance on exports.

This paper assesses the impact of the U.S. economic and financial distress on Korea from both a short- and long-run perspective. The next section discusses the U.S. situation in the context of a less-than-smooth liberalization process that has been ongoing since the 1970s throughout much of the world. This provides a broad historical perspective. Then Korea's past efforts in dealing with its own economic and financial distress are discussed; this provides a Korean historical perspective. The next section outlines the channels of how the U.S. financial crisis impacts Korea's economy and financial system; this is followed by a section that assesses the ability of the Korean economy and financial system to absorb the financial shock. Because the U.S. crisis is the direct result of the burst of the asset bubble in housing prices, the housing price situation in Korea is then reviewed and an assessment is made about whether Korea can anticipate the type of problems that plague the United States currently or affected Japan in the 1980s. The following section discusses the longer-term impact the crisis will have on Korea's growth strategy and reform program. A short concluding section ends the paper.

The Current U.S. Financial Distress in Historical Context

During the past three decades the economic and even in some cases political institutions in a wide range of countries experienced a major transition toward more open, transparent, and less collectivist structures compared with the first decades of the postwar period. In the context of economic institutional redesign, the transition has been referred to as "deregulation," "liberalization," "internationalization," or "democratization" of economic institutions. The transition has taken place in both the real and financial sectors; however, in most cases the

1. *OECD Economic Surveys: Korea* (Paris: Organization for Economic Cooperation and Development, December 2008).

financial system initiated the transition.[2] As financial liberalization became an ongoing process, it spread to the rest of the economy. Asian countries including China, Korea, and Japan have been a prominent part of the transition.

The transition process has not been smooth, however, especially in the financial sector. In 1996 an International Monetary Fund (IMF) study tabulated 133 significant banking sector problems among the IMF's 188 members from 1980 to 1996.[3] The IMF study did not include the full extent of the Korean and Japanese financial problems that brought these countries close to collapse in 1998, nor did it include the Asian financial crisis of 1997. Despite these cases of financial distress, however, the majority of countries continued with the liberalization of economic and financial institutions, and Korea recovered by 2000 and Japan by 2005 while China and India continued to grow as they opened up markets.

The recent events unfolding in the United States shocked the world because of the intensity of the distress and how rapidly the distress spread. The collapse of housing prices, recognition of nonperforming mortgage loans, collapse of secondary markets, failures of major financial institutions, and unprecedented efforts by the U.S. government to limit distress add up to a sharp reversal of progress made during the past three decades. Although the crisis environment that dominated September and October 2008 has subsided, the U.S. economy has been in recession since December 2007, balance sheets of financial institutions remain weak, and the economic and financial distress is global.

The origins of the U.S. distress can be found in the interaction of a destabilizing interrelationship among monetary policy, government support of the social contract with the U.S. population to support homeownership in general, a political decision to provide mortgage funds to low-to-moderate-income borrowers, and lax and imprudent regulation and supervision on the part of all major financial regulatory agencies. Events in the United States are still unfolding, and it is unclear how long the financial and economic distress will continue. Many of the same elements that prolonged resolution of the economic and financial distress in Japan for almost 15 years are present in the United States. A great deal depends on how government policy responds to the distress.

The events in the United States have a profound impact on the world in general and on Korea in particular. First, financial distress and recession in the United States adversely impact trade and especially trade with economies such as China, Korea, and Japan that are driven by an export-oriented growth strategy. A sharp slowdown or decline in exports will generate economic and financial stress in a wide range of countries. Second, the intellectual and policy support for market liberalization starting in the 1970s came from the United States. The United States has been an aggressive advocate of liberalization, especially in the financial sector, and successfully pressured many countries—including Korea, Japan, and, more recently, China—to liberalize. The United States also has been the most aggressive financial innovator. Much of the complexity in portfolio modeling, derivatives, secondary-market securities, credit default swaps, and leveraging has its origin in the United States. Distress in the United States combined with many other examples of financial distress mentioned above is likely to reduce enthusiasm for market reforms, at least in the short run.

Past Shocks to the Korean Economy and Lessons Learned

The Korean economy has experienced three major shocks since starting the industrialization process following the end of Korean War in 1953.

2. This point is emphasized by Thomas F. Cargill and Takayuki Sakamoto, *Japan since 1980* (New York: Cambridge University Press, 2008), chap. 3.

3. Carl-Johan Lindgren, Gillian Garcia, and Matthew I. Saal, *Bank Soundness and Macroeconomic Policy* (Washington, D.C.: International Monetary Fund, 1996).

The first shock occurred in the early 1980s as a result of the cumulative effects of inefficient government control over the economy, especially in chemicals and heavy industry and in the banking system. The Korean approach to managing the economy on average produced reasonable outcomes through the 1970s although with a high degree of variation. In the early 1980s, however, real GDP declined, trade deficits increased, and nonperforming loans began to accumulate in the state-controlled banking system. The government adopted a two-step liberalization agenda: policy from 1981 to 1988 focused on improving macroeconomic performance, and, after macroeconomic performance improved, policy was directed toward liberalization of the real and financial sectors.

Despite a number of institutional changes, such as denationalization of the banking system in the early 1980s, initiation of interest deregulation in 1988, and further interest rate deregulation policies in 1991–92 designed to completely phase out interest rate ceilings by 1997, the pace of liberalization was incomplete and flawed. The financial system was fundamentally weak and remained susceptible to a domestic or international shock despite the government reforms. In particular, international concern was expressed about the large nonperforming loan problem in the banking system, which was estimated at 10 to 20 percent of loans; the heavy influence of the Ministry of Finance in allocating bank credit to client industries and influence over central bank policy; the heavy reliance on external funding (dollars) to support domestic lending; and a politically sensitive financial regulatory system lacking transparency. These concerns were ignored by the Korean government until the second shock occurred in late 1997.

Slower growth in 1996 and 1997 and the Asian financial crisis in 1997 exposed the weak financial structure and led to rapid *won* depreciation. Regulatory authorities had paid insufficient attention to the degree banks and nonbank institutions were dependent on foreign borrowing and to the increasing weak balance sheets of the major *chaebol.* The *won* depreciated rapidly in the face of increasing capital flight as the Asian financial crisis spread. The Bank of Korea's international reserve assets were insufficient to even slow the depreciation. Korea came close to a complete economic and financial collapse by the end of 1997. Real GDP declined by 8 percent from 1997:4 to 1998:4. Korea was forced to seek the assistance of the IMF with the promise of an austerity program to prevent further *won* depreciation and a promise to accelerate reform in the financial system, corporate governance, and the *chaebol.* The reform process proceeded on a broad front,[4] and macroeconomic activity recovered after 1999. This was a major turning point in the structure of the Korean economy.

The third and least intense shock occurred in 2003. Korea reduced reliance on foreign borrowing to stimulate domestic spending after 1997; however, domestic credit expansion, especially for consumer spending, was substituted as a demand driver. The government encouraged banks to expand credit to businesses and consumers and provided tax incentives to consumers for making payments by credit cards.[5] Consumer credit card use and credit card debt expanded rapidly, and household debt increased to more than 70 percent of GDP compared with 40 percent in the past. In the past, irrational business credit expansion through the government-controlled banking system generated financial distress, and in 2002 and 2003 irrational consumer credit expansion encouraged by the government through a much less government-controlled financial system was the problem. The credit expansion burst in 2003, slowing GDP growth from 7.0 percent to 3.1 percent, and the government was forced to bail out credit card companies. The financial system stabilized, and the economy recovered and continued to grow after 2003.

4. Thomas Byrne, "The Post-Crisis Transformation of Korea's Banking System," *Korea's Economy 2005* 21:9–12; Thomas F. Cargill and Hugh Patrick, "Responses to Financial and Economic Distress in Korea and Japan," *Korea's Economy 2005* 21:17–22.

5. Diego Valderrama, "After the Asian Financial Crisis: Can Rapid Credit Expansion Sustain Growth?" *FRBSF Economic Letter* (Federal Reserve Bank of San Francisco), no. 2004–38, 24 December 2004, www.frbsf.org/publications/economics/letter/2004/el2004-38.pdf.

The three shocks—especially events in 1997 and 2003—significantly influenced financial policy in Korea in at least five ways.

- The establishment of the Financial Supervisory Commission (FSC) in 1998 and the Financial Supervisory Service (FSS) in 1999 provided prudent regulation of the financial system, reduced the politicalization of bank credit allocation, and increased overall financial system transparency.

- The Bank of Korea's enhanced formal independence and reliance on an inflation-targeting framework established a basis for price-stabilizing central bank policy and reduced the political influence on central bank credit allocation policies.

- The restructuring of the banking system after 1997 and a large government infusion of capital generated in most cases a sound banking system with improved capital-asset ratios, improved return on assets, and dramatic decline in nonperforming loans. Korean banks emerged from the process more balanced, they rely more on commercial-based models than previously, and foreign banks under foreign control have become a permanent and competitive part of the Korean financial system.[6]

- FSS prudential regulation limited leveraging by restricting loan-to-value ratios, especially for real estate credit.

- The Korea Deposit Insurance Corporation established in 1996 limited systemic risk by insuring deposits of banks, securities companies, insurance companies, merchant banks, and savings banks. This explicit form of government deposit guarantees is more transparent and less sensitive to political pressures than the previous implicit system.

The Korean economy grew at a reasonable pace after 2003 up to mid-2008. Part of this performance could be attributed to the policy responses to the three past shocks, especially the shock in 1997. Despite a general consensus, Korea's economy and financial system were sound and much more capable of dealing with domestic or international shocks; however, problem areas remained. Three are frequently mentioned.

There is concern over the significant increase in government debt. Before the 1990s there was not much government debt, but by the end of 2005 the ratio of Korean government debt to GDP was 30.7 percent. Much of this resulted from the public infusion of funds into the banking system in 1998 and 1999. Compared with the OECD average debt-to-GDP ratio of 76.9 percent, this ratio was not excessive, but, relative to Korea's previous levels of government debt, this was a major change in the role of government debt in the financial system. Second, although the major *chaebol* have adopted more commercial-based corporate governance structures and improved productivity, there is continued concern over the financial condition and sustainability of small- and medium-sized enterprises (SMEs). They have not been as aggressive as the *chaebol* in reforming their business models and increasing productivity. This is an issue not only for the SMEs but also for the banking system, as banks have a large exposure to SME loans. Third, demographic trends in terms of an aging and declining population similar to Japan's will present Korea with a wide range of economic, social, and political challenges.

Channels of Influence on Korea's Economy

U.S. financial and economic distress will continue to impact Korea through financial and real channels throughout 2009 and perhaps into 2010. These are considered the short-term impacts. Longer-term impacts fall more into a political-economy perspective discussed in a subsequent section.

Financial Channels

The U.S. financial distress influences Korea through a number of financial channels; not only are the financial channels numerous, they are sometimes opaque and complex. The more obvious include the following:

6. Byrne, "The Post-Crisis Transformation of Korea's Banking System."

- Korean private and public financial institutions, households, and businesses experienced a loss to the extent they held investments in Merrill Lynch, Lehman Brothers, Freddie Mac, Fannie Mae, AIG, and other U.S. financial institutions that experienced major market value declines;

- The decline of equity and mortgaged-backed security prices in the United States imposed a loss to the extent these assets were held by Koreans;

- The decline of equity and bond markets throughout the world imposed a loss to the extent these were held by Koreans;

- The decline of equity and bond prices in Korea imposed a loss on Koreans;

- The increased uncertainty and reduced availability of funds in the international markets tightened credit availability in Korea;

- The increase in the LIBOR (London Interbank Offered Rate) restricted Korean banks' short-term access to international funds in general and dollars in particular;

- The weakened balance sheets of Korean banks and corporations generated capital flight;

- The decline in the *won* increased the cost of servicing foreign debt;

- Portfolio losses and restricted bank credit generated problems in Korea's real estate sector and among SMEs; and

- International confidence in Korea's financial system and ability to absorb the financial shock has waned.

Real Channels

The real sector impacts are neither as numerous nor as opaque; in fact, there are essentially three real channels connecting the U.S. financial and economic distress to Korea's real sector. The first two are the result of financial impacts above, and the third is the impact of the U.S. and global recession on Korea's export sector.

- The reduced availability and increased cost of credit combined with general uncertainty reduces domestic spending;

- The reduced availability and increased cost of credit has the potential to lead to a collapse of the real estate sector, given the rapid increase in housing prices through early 2007; and

- Recession in the United States and elsewhere will impact Korea's export sector and reduce total demand for Korean output; combined with the first two impacts, this increases the potential for Korea's first decline in output since 1998.

Korea's Ability to Absorb the Financial and Real Shock

Despite a 32 percent decline in the value of the *won,* a 30 percent decline in Korean equity prices from the first of September 2008 to the first week of December 2008, and increases in interest rates across a broad spectrum of assets, the Korean financial and real sectors to date have absorbed the shock without intense economic and financial distress. Claims made in the news media that Korea might experience another 1997-type collapse are greatly exaggerated and show little understanding of the significant reforms Korea has made to its financial system since 1997. Six factors account for this relatively better response to date.

First, the real sector was growing and stable prior to the shock. Real GDP growth had been steadily increasing since the slowdown in 2003 caused by the credit card problems. In 2007:4 and 2008:1 real GDP growth was 5.7 and 5.8 percent, respectively; however, it declined to 4.8 and 3.9 percent in 2008:2 and 2008:3, respectively. Korea's prospects changed in late 2008, however. GDP growth declined by 3.4 percent in 2008:4. The unemployment rate in 2007 was stable at 3 percent; however, the unemployment rate began to trend upward in 2008 and in January 2008 was 3.3 percent. Although the Korean economy was showing signs of a slowdown before the financial shock in September, probably as a result of high energy prices, and while the economy appeared well positioned to absorb the financial and real shock, most observers have revised downward their projections of economic performance in 2009. The projections for Korea made in the latter part of 2008 now appear overly optimistic given Korea's performance in 2008:4. As of late 2008, the OECD projected Korea's economy would decline in 2009 to 2.7 percent and then increase to 4.2 percent in 2010.[7] This was more optimistic than some others suggested; for example, Moody's Investors Service as of October 2008 projected 2 percent GDP growth in 2009.[8] It appears even the less optimistic projections made in the latter part of 2008 were too optimistic. Unemployment is projected to increase to 3.6 percent in both 2009 and 2010, according to the OECD. To date, the unemployment rate appears more in line with the OECD's projections than GDP growth. Thus, Korea will not likely avoid recession and increased economic and financial distress. Nonetheless, Korea is now in much better condition than previously to deal with slower and declining performance.

Second, the banking system was sound and well positioned to absorb the shock, after having gone through a significant redesign in response to the 1997 and 2003 shocks. This is probably the most significant achievement of government reform since 1997. Government-sponsored mergers, capital injections, and greater oversight and transparency provided a foundation for viable Korean banking. In the first part of 2008, rate of return on assets (0.88 percent), nonperforming loans (0.6 percent), delinquency rates (1.7 percent for SME loans and 0.7 percent for household loans) and Bank for International Settlements capital (11.4 percent of assets) have improved significantly over the past decade.[9] Bank exposure to mortgage-backed securities, Fannie Mae, and Freddie Mac was a mere $190 million as of 14 October 2008, according to the FSS. Some news reports have suggested that Korean banks have relied on funding domestic lending with foreign borrowing; however, this is not correct, according to government officials. The loan-to-deposit ratio is around 100 when deposits are properly defined and domestic banks' foreign currency liabilities are balanced with foreign currency assets. Thus, the Korean banking system is in a stronger position compared with a decade ago, and, although it will experience some decline in the quality of its balance sheet, there is little potential for a banking problem of the magnitude of the late 1990s.

Third, although the *won* has declined significantly during the past few months as a result of capital flight and reduced demand for exports, the improved foundation of the Korea banking system combined with significant amounts of low-risk external debt and large holdings of international reserves reduce the potential for large capital flight and a downward spiral of the exchange rate. At the end of June 2008, Korea's external debt was $420 billion, of which approximately 30 percent is not subject to repayment burdens because it constitutes pre–foreign direct investment funding, foreign exchange forward hedging of precontracted future cash flows, and advanced receipts for shipbuilding contracts. In 1997 international reserves were small relative to the size of external debt, and much of the international reserve holdings was of low quality and difficult for outsiders to evaluate because of limited government transparency. In 2008 the situation is different. The relative size of reserves to external debt is large, most reserves are held in AA or better rated bonds, and the government is transparent about holdings of international reserves.

Fourth, both fiscal and monetary policy instruments are in a strong position to respond to the adverse impacts of the shock. The Korean government has run a fiscal surplus since 2000, and as of September

7. "Korea," OECD Economic Outlook: Preliminary Edition, n.d., www.oecd.org/dataoecd/6/38/20213231.pdf.

8. "South Korea's Banking Measures Should Help Alleviate Pressures," Special Comment, Moody's Investors Service, October 2008.

9. The statistics cited in this and the following sections are drawn from three sources: (1) FSS release of Governor Kim Jong-chang's 14 October 2008 conference call with institutional investors, (2) FSC press release of December 2008 entitled "Korea's Financial Market and Economy: Resilience Amid Turbulence," and (3) Bank of Korea Web site and statistics database.

2008 the surplus represented 2.4 percent of GDP. This provides the Korean government with degrees of freedom to advance funds to the financial or real sectors of the economy, to engage in spending to stimulate the economy, and to reduce taxes to stimulate the economy. Bank of Korea policy is more independent and transparent and less likely to give in to political pressure compared with the 1990s. Its inflation-targeting framework adopted in 1998 has produced a stable inflation rate on which the economy can anchor its inflationary expectations. The current consumer price index inflation target is 3 percent plus or minus 0.5 percent, and it covers the period from 2007 to 2009. The inflation rate has generally been within the target range; however, the inflation rate accelerated in early 2008 as a result of high energy costs, and it should average approximately 5 percent for 2008. The OECD predicts that inflation will decline in Korea in 2009 and 2010, and by 2010 it should be within the current range.

Thus, fiscal policy has considerable degrees of freedom to deal with adverse impacts on the Korean economy, and Bank of Korea policy has provided a stable environment and has established the Bank as a credible central bank.

Fifth, the government response to the shock has been rapid and transparent. Reports released by the FSS and the FSC as well as monetary policy statements by the Bank of Korea provide much useful information to assess the condition of the financial system and the economy. The Korean government has initiated a wide range of actions to maintain foreign confidence, to reduce the impact on the shock on the financial system, and to cushion the economy in the face of declining output. Banks are being required to increase capital; $100 billion of foreign debt owed by banks is being guaranteed by the government; credit will be directed toward SMEs to overcome short-term cash flow problems; tax reductions of various types are being discussed; and the Bank of Korea lowered the base rate from 5.25 percent in August 2008 to 2.00 percent in early February 2009.

Sixth, Korea is unlikely to experience a collapse of housing prices as in the United States. This issue is discussed in detail in the following section.

Housing Prices in Korea

In early 2007 a review of housing prices in Korea in the context of an asset bubble taxonomy suggested by Minsky outlined implications for Bank of Korea policy and compared the potential for a Japan-like housing problem.[10] The paper was published just as housing prices in the United States were beginning to collapse, according to the S&P Case-Shiller national indexes; that is, house prices peaked in late 2006 and started to decline in 2007. Even as housing prices began to decline, the full magnitude of the problem had not emerged. The 2007 paper concluded, ". . .increases in housing prices in Korea are likely not sustainable, that a downward adjustment is more likely than not, but that the problem is not near a magnitude that requires aggressive monetary policy at this time. Instead, the BOK [Bank of Korea] would do well to 'learn against' the potential housing bubble. This appears to be the policy currently being implemented."[11] In hindsight, this conclusion suggests two questions: First, did the pace of housing price increases slow in 2007 and 2008? Second, is Korea susceptible to a housing collapse?

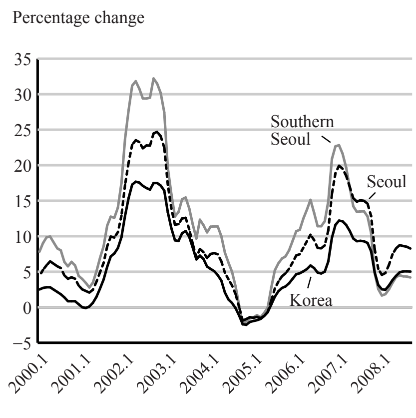
Figure 1 and ***Figure 2*** illustrate the annual percentage change in the housing and apartment purchase price index for Korea, Seoul, and southern Seoul from January 2000 to September 2008, respectively.[12] Both figures illustrate considerable price variation; however, only for a short period in late 2004 and early 2005 did prices actually decline. In early 2007 there was concern over the rapid increase in housing and apartment prices; however, it now appears house and apartment prices have

10. Thomas F. Cargill and Federico Guerrero, "Bank of Korea Policy and Asset Bubbles," *Korea's Economy 2007* 23:8–18; Hyman P. Minsky, "The Financial Instability Hypothesis: Capitalistic Processes and the Behavior of the Economy," in *Financial Crises: Theory, History and Policy,* ed. C. P. Kindleberger and J. P. Laffargue (Cambridge: Cambridge University Press, 1982).

11. Cargill and Guerrero, "Bank of Korea Policy and Asset Bubbles," 8.

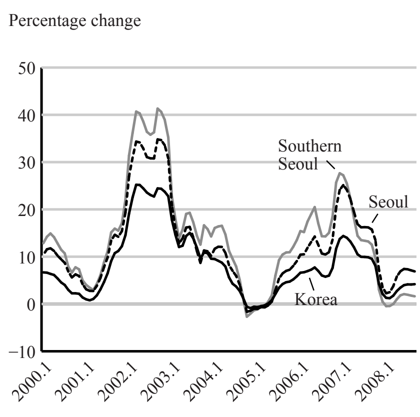
12. Data were provided by the Bank of Korea.

Figure 1: **Percentage Change in the Housing Price Index in Korea, in Seoul, and in Southern Seoul January 2000–September 2008**



Source: Bank of Korea.

Figure 2: **Percentage Change in the Apartment Price Index in Korea, in Seoul, and in Southern Seoul, January 2000–September 2008**



Source: Bank of Korea.

stabilized around an annual rate of approximately 5 to 7 percent.

Three reasons account for why a housing problem did not materialize in Korea and is not likely to become a problem as it has in the United States or was in Japan. First, the Bank of Korea adopted a policy of "leaning against the housing bubble." The Bank of Korea raised the base rate of 3.5 percent in October 2005 in several steps, to a high of 5.25 percent in August 2007. Second, mortgage credit was not as large a part of the Korean economy as it was in the United States. The ratio of mortgage credit to GDP in Korea is 33.4 percent while in the United States the ratio is 72.3 percent. Mortgage delinquency rates after declining from 2004 to 2007 increased in Korea from 2007 to 2008 to about 0.5 percent compared with the approximate 7 percent delinquency rate in the United States in the latter part of 2008. Third, and probably most important, starting in 2002 Korean regulatory authorities imposed significant prudential requirements on mortgage loans; a key component was a loan-to-value ratio of 40 to 60 percent and a debt-to-income ratio of 40 percent. Had these types of regulations been in place in the United States, there would likely not have been a housing bubble and burst. The relatively low ratio in Korea is important because, even if housing prices decline, individuals would still retain positive equity and still have incentive to meet mortgage payments. Declining housing prices are more serious in the United States because even many prime mortgage loans have been made with low down payments and because mortgage credit is generally given without recourse.

Hence, Korea did have the potential of a housing problem in early 2007 although it was not of the magnitude of other countries. The pace of housing price increases declined and, because of stricter prudential requirements on mortgage credit, Korea is not likely to experience a housing problem as Japan did in the 1990s or as currently exists in the United States. The problem in Japan was a close interrelationship among bank capital, bank lending, equity prices, and real estate prices not prominent in Korea. The problem in the United States was imprudent lending and borrowing that resulted in widespread negative equity in housing when prices began to decline. In both Japan and the United States the housing problem was exacerbated by easy monetary policy. This is not to claim an absence of problems in Korea's housing sector: construction companies are overextended and a large number have declared bankruptcy, many apartment projects remain unsold, and real estate prices are likely to decline in 2009. In spite of this, it is unlikely housing will become the problem it was for Japan and currently is for the United States. In Japan and the United States housing was at the center of the financial and economic distress, while in Korea housing is responding more to the global slowdown than to any fundamental internal instability.

Long-Term Impact on Korea

The impact of the worldwide financial distress on Korea to date has been more serious than anticipated in the latter part of 2008. Korea should be concerned, and, on the positive side, the Korean government has not been complacent, if this can be judged by its policy reaction to date. There is concern, however, that the Korean government might not fully comprehend the longer-run impacts likely to emerge from the U.S. economic and financial distress.

Henry Kaufman, in an insightful review of how the credit crisis will impact economic behavior in the United States, states that the current distress is the most serious threat to the financial system experienced since the 1930s. Kaufman believes also that, although the financial stress in terms of bank failures and economic distress in terms of real GDP, prices, and unemployment come nowhere near the magnitudes of the 1930s, today's overall financial and economic distress is a major event in U.S. history and will influence long-run behavior and government policy.[13]

Of the several changes in behavior or policy outlined by Kaufman, the following three are the most relevant for Korea's future:

- International portfolio diversification has been undermined;
- The era of ballooning nonfinancial debt has ended; and
- Americans will begin to save again.

Korea has benefited greatly from internationalization of finance. The rapid spread of the U.S. financial distress to much of the world because of the internationalization of domestic portfolios combined with the complexity of financial asset instruments has raised concerns about the internationalization of finance. Institutional redesign will take place in the near future, and there is concern that governments might move to limit financial innovation and credit growth, thereby in the long run limiting Korea's economic potential. Kaufman notes that some redesign will be necessary because of lessons learned from the current situation, but that governments will need to be careful to balance the need to limit systemic risk with the need to allow financial innovation and internationalization of finance to continue.

Korea as an export-oriented economy faces an even more serious problem if Americans commence saving and reduce debt. The United States since the 1980s has been on a consumption binge financed by credit growth. Domestic consumption by households, business, and government combined exceeded domestic production, and, as a result, the United States has been running increasingly large current account deficits until only recently, when the size of the deficit declined somewhat. Starting in 1990 the current account deficit has steadily increased in absolute terms and increased relative to GDP. In the early 1990s, the deficit represented about 0.25 percent of GDP; however, by 2007, the deficit represented about 1.2 percent of GDP. If Kaufman is correct and Americans begin to increase the saving rate and reduce reliance on credit, this will adversely impact any export-oriented country for which the United States is a large market.

This is especially true for Korea. The percentage of total exports to the United States in 2004 averaged about 16 percent. The percentage has declined since 2004 and as of late 2008 stood at about 10 percent. Korea, as well as other export-oriented economies such as Japan and China, is likely to see a long-term decline in exports to the United States if the U.S. saving rate increases and nonfinancial debt declines. These are likely events, and Korean officials might consider the longer-term impacts on the U.S. distress in this context.

In addition to a shift in economic behavior in the United States toward greater saving, political developments in the United States as well as in other industrialized countries suggest protectionist measures are more likely than at any other time during the past three decades. A shift toward protectionism

13. Henry Kaufman, "How the Credit Crisis Will Change the Way America Does Business," *Wall Street Journal,* 6 December 2008.

in the United States and elsewhere would adversely impact Korea's growth potential. Korea and other exported-oriented economies have benefited greatly from the trade liberalization during the past three decades, but protectionism is a growing risk.

The financial distress in the United States is likely to change attitudes about financial liberalization in Korea. Prior to 1997 Korea's financial liberalization process was more rhetoric than substance; however, the crisis in 1997 and 1998 convinced policymakers that the old regime needed to be redesigned. Korea adopted a meaningful reform process and during the past decade has accomplished many improvements in the stability of the financial system. In fact, these accomplishments explain much of the reason why the Korean economy has been able to absorb the financial and real shocks to date. The crisis has raised concerns about the pace of liberalization, however, and how far to permit innovation, especially in terms of securitization. Korean officials have stated that current events will not detour the liberalization process directed toward financial institutions and markets, but at the same time the political economy context suggests that a policy of further liberalization will be influenced by what happened, why it happened, and how events will evolve in 2009 and 2010. Thus, at a minimum Korea will become a little more cautious in pursuing financial liberalization. Unlike the potential decline of the U.S. market for exports and shift toward protectionism, this development may or may not be a negative.

Concluding Comment

The Korean financial system and economy have absorbed the U.S. economic and financial distress reasonably well compared with 1997–98. There is evidence that financial institution balance sheets are weaker, but the reforms made since 1997 and government reaction have reduced the potential for serious systemic problems. A reasonable argument can be made that Korea is unlikely to experience a housing problem of the magnitude experienced in Japan in the past or currently in the United States. In the short run, the Korean economy will decline in 2009; Korea's dependence of exports makes it more susceptible to world economic conditions that are largely outside of Korea's power to influence.

In this regard, events in the United States will have a long-run impact on economic behavior and will likely reduce Korea's market for exports to the United States. Given the significant importance of the U.S. market, this might offer another opportunity for Korean authorities to reconsider their export-oriented growth strategy. The tendency to blame deregulation and liberalization for the current problems combined with the real need to make some institutional changes may generate policies that limit internationalization of finance. Korea will be adversely impacted. In addition, Korea's own regulatory reforms may be toned down in the light of recent events.

Thus, Korea has absorbed the recent shocks reasonably well in that systemic risk has not increased significantly as it did in 1998. Much of this is due to the policy responses to the major shocks experienced by the Korean economy during the past decade. Nonetheless, the sharp decline in GDP in 2008:4, the sharp decline in exports, and the increase in the unemployment rate suggest Korea will experience recession and increased economic and financial distress in 2009. In addition, Korea continues to face long-run issues that have been well documented. The recent events in the United States introduce two new issues—the likely decline in the U.S. market for Korean exports and the potential for regulatory redesign to limit innovation and credit growth.

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